
financial regulatory reform lawflash

July 20, 2012

CFTC Finalizes Commercial End-User Exception

Final rules relating to the commercial end-user exception to the clearing requirements of the Dodd-Frank Act clarify who can take advantage of the exception and the requirements for doing so.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) contains significant changes to the ways in which over-the-counter derivatives are regulated. Transactions identified as “swaps” and “security-based swaps” will be regulated under the Act, and the definitions of those terms are broad enough to encompass most over-the-counter derivatives. Most standardized swap transactions likely will be subject to central clearing and exchange-style trading requirements, and certain parties to those transactions will be subject to capital, margin, registration, reporting, recordkeeping, and business conduct requirements.

Background

Under the Act, the Commodity Futures Trading Commission (CFTC) is given authority to regulate swaps and the Securities and Exchange Commission (SEC) is given authority to regulate security-based swaps. These regulators have broad authority to promulgate rules implementing the legislation. The two agencies are required to coordinate and harmonize their respective regulation and, in certain cases, are required to engage in joint rulemaking.

The CFTC and SEC are required to adopt rules under the Act establishing criteria for determining those swaps and security-based swaps that are required to be cleared through a central clearing organization. Generally, the Act makes it unlawful to enter into a swap or security-based swap that is required to be cleared, unless the swap or security-based swap is submitted for clearing. Recognizing that the reforms contemplated by the Act may result in a hardship to commercial (as opposed to financial) enterprises, Congress included an exception to the clearing requirements of the Act for certain commercial enterprises that utilize swaps and security-based swaps. This exception is commonly known as the “commercial end-user exception.”

Under the Act, if one party to a swap or security-based swap is *not* a “financial entity” (a term that includes swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, private funds, employee benefit plans, and banking entities), and that party (a commercial end-user) is using the swap or security-based swap to hedge or mitigate commercial risk and notifies the relevant commission how it generally meets its financial obligations associated with noncleared swaps and security-based swaps, then such swap or security-based swap does not have to be cleared. The commercial end-user may, however, still choose to clear the swap or security-based swap, and if so, may also choose the clearing organization at which to clear the transaction. If the commercial end-user is a public company, an appropriate committee of the board of directors must approve any election not to clear the swap or security-based swap.

Final Rules Address Exception Requirements

In furtherance of its statutory mandate, the CFTC has adopted final rules that address the requirements of the commercial end-user exception. These final rules were published in the *Federal Register* on July 19, 2012, and will become effective September 17, 2012. However, compliance will not be necessary or possible until swaps

become subject to the clearing requirement of the Act, which is now expected to be implemented in stages starting at the end of this year. The SEC has not yet adopted final rules in this area.

The final rules are contained in Part 39.6 of the CFTC regulations and largely parallel the statutory mandate. In order to take advantage of the commercial end-user exception, the party electing the exception

- may not be a financial entity (importantly, the CFTC has provided relief to smaller banking entities by excluding them from such definition);
- must be using the swap to hedge or mitigate commercial risk; and
- must provide or cause to be provided certain itemized information to a registered swap data repository (SDR) or the CFTC if no SDR is available.

The information required to be reported consists of the following:

- Notice of election of the end-user exception
- The identity of the electing party
- The following, unless the same has already been provided in a current optional annual filing:
 - Whether the electing party is a financial entity
 - Whether the electing party is using the swap to hedge or mitigate commercial risk
 - How the electing party generally meets its financial obligations associated with entering into noncleared swaps by identifying categories of ways in which it generally meets such obligations
 - Whether the electing party is an issuer of public securities and, if so, certain related information, the most important of which is whether an appropriate committee of the electing party's board of directors has reviewed and approved the decision to enter into uncleared swaps

A swap is used to hedge or mitigate commercial risk if the swap

- is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise where the risks arise from certain enumerated sources of variability; or
- qualifies as bona fide hedging for purposes of an exemption from position limits under the Commodity Exchange Act; or
- qualifies for hedging treatment under applicable identified accounting rules; **and**
- is not used for a purpose that is in the nature of speculation, investing, or trading, and is not used to hedge or mitigate the risk of another swap or security-based swap position unless such position itself is used to hedge or mitigate commercial risk.

Implications

Use of the commercial end-user exception will enable entities that are not financial entities to customize their derivative transactions and avoid the standardized margining regime associated with cleared products. However, compliance with the various elements of the end-user exception is determined on a swap-by-swap basis, which requires a careful analysis of the exception and related CFTC commentary. For example, a nonfinancial entity's swaps that do not hedge or mitigate commercial risk and that are subject to the mandatory clearing requirement will need to be cleared even if the nonfinancial entity qualifies for the end-user exception for its other swaps. Parties considering using the commercial end-user exception should begin to familiarize themselves with the exception prior to the time it becomes effective.

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